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IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

ZENITH RADIO CORPORATION, et al.,
Petitioners,

vs.

ROBERT EDWARD McGRATH,
Respondent.

SUPPLEMENTAL BRIEF OF RESPONDENT

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THE DISTINCTION DRAWN BY THE SEVENTH CIRCUIT BETWEEN THE PRESENT CASE AND *FREDRIKSEN* v. *POLOWAY* ALSO APPLIES TO *CANFIELD* v. *RAPP & SON, INC.* THE CASE AT BAR, INVOLVING A CLAIM OF FRAUD BY THE SELLER OF A SMALL BLOCK OF STOCK, IS NOT A PROPER VEHICLE TO REVIEW THE APPLICABILITY OF THE SECURITIES LAWS TO A CLAIM OF FRAUD BY THE PURCHASER OF 100 PERCENT OF A CORPORATION'S STOCK.

Petitioners have filed a supplemental brief citing *Canfield* v. *Rapp & Son, Inc.*, CCH Fed. Sec. L. Rep. ¶ 98, 227 (July 6, 1981) in support of their contention that there is a conflict among the circuits of the court of appeals on the scope of Rule 10b-5 and the applicability of the "economic reality" test.

Initially it should be noted that this is an issue which petitioners did not raise in the district court nor in the court of appeals until they petitioned for rehearing. Although this issue

was raised in their petition to this Court, petitioners' reply brief contains no reply to the respondent's answer regarding this issue. Through three courts, petitioners have jumped from one issue to another in an effort to prevent application of the securities laws to petitioners' fraudulent conduct.

Second, the *Canfield* case and *Archor Darling Inc., Inc.* v. *Suozzo,* ¶ 97, 933 CCH Fed. Sec. L. Rep. (E. D. Pa. March 16, 1981), also cited in petitioners' supplemental brief, only serve to emphasize the distinction between *Fredriksen* and the present case drawn by the Seventh Circuit (651 F. 2d at 467 n. 5) and the respondent's brief at pp. 10-12.

Significantly, *Fredriksen, Canfield* and *Anchor* all involve suits by a single plaintiff-purchaser of 100 percent of the stock of a corporation. As a result, each of those cases applied the three elements of the "economic reality" test from the standpoint of a single purchaser of 100 percent of the stock of a corporation. The present case involves a claim of fraud by a plaintiff-seller, respondent McGrath, who was selling a small block of Basford stock. An analysis of the three elements of the test from the standpoint of McGrath illustrates the distinction drawn by the Seventh Circuit.

The three elements of the "economic reality" test are: 1) an investment in a common venture; 2) premised on a reasonable expectation of profits; 3) to be derived from the entrepreneurial or managerial efforts of others. *United Housing Foundation, Inc.* v. *Forman,* 421 U. S. 837, 852 (1975). When McGrath purchased his shares he was investing in a common venture. He was sharing or pooling his funds with the other Basford employees who were also stockholders of Basford. McGrath's purchase of stock was premised on a reasonable expectation of profit which was to be derived from the managerial efforts of others—the executives and supervisory employees of Basford. It is true that McGrath was one of the managerial personnel, but he was only one. Consequently, when McGrath purchased his shares of stock they qualified as a security under

the "economic reality" test. Petitioners do not explain how the stock could change character between the time McGrath purchased it and the time he sold it to petitioners other than to assert that they were purchasing 100 percent of the Basford stock. This does not alter the fact that McGrath and the other Basford stockholders were selling what they had purchased as securities and that both their purchase and sale of these securities were entitled to the protection of the securities laws.

When a single purchaser elects to purchase 100 percent of the stock of a corporation, there may be justification for saying that in actuality he is purchasing the assets of the corporation and the mere use of the stock purchase vehicle does not entitle him to the protection of the securities laws. At the time such a purchaser entered into the transaction, he was not investing in a security within the meaning of the securities laws. As a result, fraud which occurred in that transaction cannot be redressed under the securities laws. However, the same cannot always be said for the sellers, who are on the other side of the transaction. If they, in fact, did purchase securities within the meaning of the securities laws, then they are entitled to the protection of those laws when fraud occurs at the time they choose to sell those securities. This is true even if they sell to a purchaser who elects to buy 100 percent of such outstanding securities.

In the present case it is the seller, not the purchaser, who has sought the protection of the securities laws. Thus, the elements of the "economic reality" test must be analyzed from the standpoint of the seller. When this is done, the Basford stock which McGrath sold was a security and the securities laws may be utilized by him to recover damages for petitioners' fraudulent conduct.

Petitioners' continued citation of numerous decisions regarding the applicability of the securities laws establishes jurisdiction over the federal securities law claim and the pendent state law claims, contrary to petitioners' jurisdictional position. Even if petitioners' contention that the court improp-

erly decided the securities law's issues was correct, it is of little moment because, as the very conflict among the cases on which petitioners rely illustrates, there is no authority establishing beyond rational argument that there is no federal claim in this case. In the absence of such authority, there is federal subject matter jurisdiction, which, in turn, supports the pendent common law fraud count. Petitioners do not contend that the common law fraud count does not support the verdict. All of this forcefully argues for the denial of the petition for writ of certiorari.

Respectfully submitted,

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